## CASE 13-1

### Coca-Cola: Consolidation Versus Equity Method

Coca-Cola (Coke) [KO] is the largest soft drink firm in the world. However, Coke does not bottle and distribute its beverages; that activity is carried out by affiliates in which Coke has a large equity interest.

Coca-Cola Enterprises (Enterprises) [CCE] is the world's largest marketer and distributor of Coke products. The relationship between the two firms is complex:

1. Enterprises produces virtually all its products under license from Coke and buys soft drink syrup, concentrates, and sweeteners directly from or through Coke.
2. Coke provides national advertising as well as local marketing support for Enterprises' products.
3. Through programs such as 'Jumpstart' that are designed to accelerate the placement of cold drink equipment, Coke provides funding to Enterprises to help set up the infrastructure required to distribute its products.
4. Approximately 90% of Enterprises' sales volume is generated through the sale of products of The Coca-Cola Company; raw materials purchased from Coke account for over 50% of Enterprises' cost of goods sold. To a great extent, Coke controls Enterprises' products and input costs.
5. Three members of Enterprises' board of directors are current officers of Coke.

It would not be an understatement to suggest that Enterprises (and Coke's other affiliated bottling companies) are an integral part of Coke's success, providing an outlet for its products. However, by keeping its ownership below 50%, Coke has been able to use the equity method to report its interest in Enterprises and the other bottlers.

Exhibit 13C1-1 contains condensed 2001 financial statements of Coke and Coca-Cola Enterprises. The following information with respect to its ownership interest in its bottlers is excerpted from Coke's financial statements:

- Coca-Cola Enterprises is the largest soft drink bottler in the world. Coke owns approximately 38 percent of the outstanding common stock of Coca-Cola Enterprises and, accordingly, accounts for its investment by the equity method of accounting.
- At December 31, 2001, the Company owned approximately 35 percent of Coca-Cola Amatil, an Australia-based bottler of Company products that operates in 12 countries.
- As a result of a merger in 2000 between Coca-Cola Beverages and Hellenic Bottling Company S.A. to form the combined entity Coca-Cola HBC S.A., Coke's previous 50.5% ownership in Coca-Cola Beverages was reduced to a 24% share of the combined entity Coca-Cola HBC S.A.
- Coke states in its MD&A that

  > In line with our long-term bottling strategy, we consider alternatives for reducing our ownership interest in a bottler. One alternative is to combine our bottling interests with the bottling interests of others to form strategic business alliances. Another alternative is to sell our interest in a bottling operation to one of our equity investee bottlers. In both of these situations, we continue to participate in the bottler's results of operations through our share of the equity investee's earnings or losses.

Additional information that is also relevant to analysis of the bottling affiliates is presented below:

- 2001 Financial Information ($ in millions)

| | | |
|---|---|---|
| Intercompany sales | From Coke to Enterprises | $3,900 |
| | From Enterprises to Coke | 395 |
| Net marketing payments | From Coke to Enterprises | 606 |

(Continued on page W90.)

**EXHIBIT 13C1-1. THE COCA-COLA COMPANY AND COCA-COLA ENTERPRISES**
**Condensed 2001 Financial Statements (in millions)**

| Balance Sheets at December 31, 2001 | Coke | Enterprises |
|---|---|---|
| *Current Assets* | | |
| Cash and marketable securities | $ 1,934 | $ 284 |
| Trade accounts receivable | 1,882 | 1,540 |
| Inventories | 1,055 | 690 |
| Prepaid expenses and other assets | 2,300 | 362 |
| | $ 7,171 | $ 2,876 |
| *Investments* | | |
| Equity method investments | | |
| Coca-Cola Enterprises | 788 | — |
| Coca-Cola Amatil Limited | 432 | — |
| Coca-Cola HBC S.A | 791 | — |
| Other, principally bottling companies | 3,117 | — |
| Cost method investments, principally bottling companies | 294 | — |
| Other assets | 2,792 | — |
| | $ 8,214 | — |
| Property, Plant, and Equipment (Net) | 4,453 | 6,206 |
| Intangible assets* | 2,579 | 14,637 |
| **Total assets** | **$22,417** | **$23,719** |
| *Current Liabilities* | | |
| Accounts payable and accrued liabilities | $ 4,530 | $ 2,610 |
| Accounts payable to The Coca-Cola Company | | 38 |
| Deferred cash payments from The Coca-Cola Company | | 70 |
| Notes payable and current debt | 3,899 | 1,804 |
| | $ 8,429 | $ 4,522 |
| *Noncurrent Liabilities* | | |
| Long-term debt | 1,219 | 10,365 |
| Other long-term liabilities | 961 | 1,166 |
| Deferred taxes | 442 | 4,336 |
| Deferred cash payments from The Coca-Cola Company | — | 510 |
| | $ 2,622 | $16,377 |
| *Shareholders' Equity* | | |
| Preferred stock | — | 37 |
| Common stock | 873 | 453 |
| Capital surplus | 3,520 | 2,527 |
| Retained earnings | 23,443 | 220 |
| Other comprehensive income | (2,788) | (292) |
| Treasury stock | (13,682) | (125) |
| | $11,366 | $ 2,820 |
| **Total liabilities and equity** | **$22,417** | **$23,719** |

*Intangible assets of Coke consist primarily of goodwill and trademarks. Intangible assets for Enterprises consist primarily of franchise rights to bottle Coca-Cola products.

**EXHIBIT 13C1-1** *(continued)*

| Income Statement, Year Ended December 31, 2001 | Coke | Enterprises |
|---|---|---|
| Net operating revenues | $20,092 | $15,700 |
| Cost of goods sold | (6,044) | (9,740) |
| **Gross profit** | **$14,048** | **$ 5,960** |
| Selling, administrative, and general expenses | (8,696) | (5,359) |
| **Operating income** | **$ 5,352** | **$ 601** |
| Interest income | 325 | — |
| Interest expense | (289) | (753) |
| Equity income | 152 | — |
| Other income | 130 | 2 |
| **Income before taxes** | **$ 5,670** | **$ (150)** |
| Income taxes | (1,691) | 131 |
| **Income before cumulative effect of accounting change** | **$ 3,979** | **$ (19)** |
| Cumulative effect of accounting change | (10) | (302) |
| **Net income** | **$ 3,969** | **$ (321)** |
| Preferred dividends | — | (3) |
| **Net income (loss) applicable to common shareholders** | **$ 3,969** | **$ (324)** |

| Cash Flow Statements, Year Ended December 31, 2001 | Coke | Enterprises |
|---|---|---|
| **Cash Flow from Operations** | | |
| Net income | $ 3,969 | $ (324) |
| Equity income, net of dividends | (54) | |
| Other adjustments | 195 | 1,438 |
| | **$ 4,110** | **$ 1,114** |
| **Cash Flows from Investing Activities** | **(1,188)** | **(2,010)** |
| **Cash Flows from Financing Activities** | | |
| Debt financing | (926) | 946 |
| Issue and repurchase of stock | (113) | 12 |
| Dividends | (1,791) | (72) |
| | **$ (2,830)** | **$ 886** |
| **Effect of exchange rate changes** | **(45)** | **—** |
| **Change in cash** | **$ 47** | **$ (10)** |

*Source:* Adapted from 2001 annual reports of The Coca-Cola Company and Coca-Cola Enterprises.

- Prior to 2001, Enterprises had recorded payments received from Coke for programs such as 'Jumpstart' as offsets to expenses incurred in constructing the infrastructure. Starting in 2001, Enterprises changed its accounting and recorded the money received as obligations to Coke to be amortized over the life of the programs. Coke, itself, records these expenditures as part of Other Assets and amortizes them over time.

Required:

1. Given the relationship between Coke and Enterprises, discuss the appropriateness of Coke's use of the equity method to account for its investment in Enterprises.
2. Prepare a 2001 balance sheet, income statement, and cash flow statement for Coke, with Enterprises fully consolidated.
3. Compute the following ratios for Coke (as reported), Enterprises, and Coke after full consolidation of Enterprises:
   - **(a)** Current ratio
   - **(b)** Debt-to-equity
   - **(c)** Debt-to-tangible equity
   - **(d)** Debt-to-assets
   - **(e)** Current ratio
   - **(f)** Debt-to-equity
   - **(g)** Debt-to-tangible equity
   - **(h)** Return on assets
   - **(i)** Return on tangible assets
   - **(j)** Return on equity
   - **(k)** Return on tangible equity
   - **(l)** Times interest earned
   - **(m)** Inventory turnover
   - **(n)** Receivable turnover

**EXHIBIT 13C1-2. THE COCA-COLA COMPANY AND SUBSIDIARIES**
**Supplementary Data**

*Notes to Consolidated Financial Statements*

*Other Equity Investments*

Operating results include our proportionate share of income (loss) from our equity investments. A summary of financial information for our equity investments in the aggregate, other than Coca-Cola Enterprises, is as follows

(in millions):

| December 31, | 2001 | 2000 | |
|---|---|---|---|
| Current assets | $ 6,013 | $ 5,985 | |
| Noncurrent assets | $17,879 | $19,030 | |
| Total assets | $23,892 | $25,015 | |
| Current liabilities | $ 5,085 | $ 5,419 | |
| Noncurrent liabilities | $ 7,806 | $ 8,357 | |
| Total liabilities | $12,891 | $13,776 | |
| Shareowners' equity | $11,001 | $11,239 | |
| Company equity investment | $ 4,340 | $ 4,539 | |
| **Year Ended December 31,** | **2001** | **2000** | **1999** |
| Net operating revenues (1) | $19,955 | $21,423 | $19,605 |
| Cost of goods sold | $11,413 | $13,014 | $12,085 |
| Gross profit (1) | $ 8,542 | $ 8,409 | $ 7,520 |
| Operating income (loss) | $ 1,770 | $ (24) | $ 809 |
| Cash operating profit (2) | $ 3,171 | $ 2,796 | $ 2,474 |
| Net income (loss) | $ 735 | $ (894) | $ (134) |

Notes: Equity investments include non-bottling investees.

(1) 2000 and 1999 Net operating revenues and Gross profit have been reclassified for EITF Issue No. 00-14 and EITF Issue No. 00-22.

(2) Cash operating profit is defined as operating income plus depreciation expense, amortization expense and other non-cash operating expenses.

Net sales to equity investees other than Coca-Cola Enterprises were $3.7 billion in 2001, $3.5 billion in 2000, and $3.2 billion in 1999. Total support payments, primarily marketing, made to equity investees other than Coca-Cola Enterprises, the majority of which are located outside the United States, were approximately $636 million, $663 million, and $685 million for 2001, 2000, and 1999, respectively.

In February 2001, the Company reached an agreement with Carlsberg A/S (Carlsberg) for the dissolution of Coca-Cola Nordic Beverages (CCNB), a joint venture bottler in which our Company had a 49 percent ownership. In July 2001, our Company and San Miguel Corporation (San Miguel) acquired Coca-Cola Bottlers Philippines (CCBPI) from Coca-Cola Amatil Limited (Coca-Cola Amatil).

In November 2001, our Company sold nearly all of its ownership interests in various Russian bottling operations to Coca-Cola HBC S.A. (CCHBC) for approximately $170 million in cash and notes receivable, of which $146 million in notes receivable remained outstanding as of December 31, 2001. These interests consisted of the Company's 40 percent ownership interest in a joint venture with CCHBC that operates bottling territories in Siberia and parts of Western Russia, together with our Company's nearly 100 percent interests in bottling operations with territories covering the remainder of Russia.

In July 2000, a merger of Coca-Cola Beverages plc (Coca-Cola Beverages) and Hellenic Bottling Company S.A. was completed to create CCHBC. This merger resulted in a decrease in our Company's equity ownership interest from approximately 50.5 percent of Coca-Cola Beverages to approximately 24 percent of the combined entity, CCHBC.

In July 1999, we acquired from Fraser and Neave Limited its ownership interest in F&N Coca-Cola Pte Limited.

If valued at the December 31, 2001, quoted closing prices of shares actively traded on stock markets, the value of our equity investments in publicly traded bottlers other than Coca-Cola Enterprises exceeded our carrying value by approximately $800 million.

*Source:* Coca-Cola 2001 Annual Report

4. Discuss the differences in the ratios in part 3 between Coke as reported and after the consolidation of Enterprises.
5. Repeat parts 2 through 4, but using proportionate consolidation for Enterprises.
6. Exhibit 13C1-2 contains summarized data regarding Coke's other bottling affiliates (excluding Enterprises) accounted for using the equity method. Discuss the expected effect of:
   **(i)** Full consolidation on Coke's financial statements.
   **(ii)** Proportionate consolidation
7. Discuss the expected effect of the FASB exposure draft on consolidation (Box 13-3) on Coke's accounting treatment of its bottling affiliates.
8. Coke states "In line with our long-term bottling strategy, we consider alternatives for reducing our ownership interest in a bottler." Discuss Coke's motivation to reduce such ownership interests.
9. As a financial analyst, discuss the advantages and disadvantages of viewing Coke, with its bottling affiliates:
   **(i)** On the equity method
   **(ii)** Proportionately consolidated
   **(iii)** Fully consolidated